

STATE OF NEW YORK

DIVISION OF TAX APPEALS

In the Matter of the Petition	:	
of	:	
CHARLES E. BENISCH	:	DETERMINATION
for Redetermination of a Deficiency or for	:	
Refund of Personal Income Tax under Article 22	:	
of the Tax Law for the Years 1983 and 1984.	:	

Petitioner, Charles E. Benisch, 108 Remington Road, Manhasset, New York 11030, filed a petition for redetermination of a deficiency or for refund of personal income tax under Article 22 of the Tax Law for the years 1983 and 1984 (File No. 806775).

A hearing was held before Thomas C. Sacca, Administrative Law Judge, at the offices of the Division of Tax Appeals, Two World Trade Center, New York, New York, on July 24, 1990 at 1:15 P.M., with all briefs submitted by October 9, 1990. Petitioner appeared by Lopez, Edwards, Frank & Co. (Felix A. Tornatore, C.P.A.). The Division of Taxation appeared by William F. Collins, Esq. (Andrew J. Zalewski, Esq., of counsel).

ISSUE

Whether petitioner is entitled to the treatment of certain distributions from subchapter "S" corporations as personal service income subject to the maximum tax limitation.

FINDINGS OF FACT

On August 20, 1984, petitioner, Charles E. Benisch, filed a 1983 New York State Resident Income Tax Return. An application for automatic extension of time to file to August 15, 1984 had been filed by petitioner on April 13, 1984.

On October 15, 1985, petitioner filed a 1984 New York State Resident Income Tax Return. An application for automatic extension of time to file to August 15, 1985 had been filed by petitioner on April 12, 1985 and petitioner requested, and was granted, an additional extension to October 15, 1985 in which to file.

Throughout the years 1983 and 1984 petitioner owned 100 percent of Don Travel Service NY, Inc. and Don Travel Service of Westchester, Inc., electing small business corporations within the meaning of Tax Law § 660. Both corporations were involved in the travel agency business.

For the year 1983, petitioner reported \$1,967,956.00 as personal service income subject to the maximum tax limitation. The personal service income as shown was composed of the following:

Wage/salary income from Don Travel Service NY, Inc. (per wage and tax statement)	\$ 478,000.00
Wage/salary income from Don Travel Service of Westchester, Inc. (per wage and tax statement)	24,000.00
Miscellaneous Income	1,770.00
Distribution from Don Travel Service NY, Inc. (subchapter "S" distribution)	893,113.00
Distribution from Don Travel Service of Westchester, Inc. (subchapter "S" distribution)	<u>571,073.00</u>
	\$1,967,956.00

For the year 1984, petitioner reported \$2,060,577.00 as personal service income subject to the maximum tax limitation. The personal service income as shown was composed of the following:

Wage/salary income from Don Travel Service NY, Inc. (per wage and tax statement)	\$ 472,288.00
Wage/salary income from Don Travel Service of Westchester, Inc. (per wage and tax statement)	29,000.00

Miscellaneous Income	1,372.00
Distribution from Don Travel Service NY, Inc. (subchapter "S" distribution)	888,857.00
Distribution from Don Travel Service of Westchester, Inc. (subchapter "S" distribution)	<u>669,060.00</u>
	\$2,060,577.00

On its income tax return for 1983, Don Travel Service NY, Inc. listed distributions, other than dividend distributions, paid during the year to petitioner of \$832,683.00 and undistributed income of \$41,005.00, for a total of \$893,113.00. For 1984, this same corporation listed distributions, other than dividend distributions, paid during the year to petitioner of \$303,203.00 and undistributed income of \$585,654.00, for a total of \$888,857.00.

On its income tax return for 1983, Don Travel Service of Westchester, Inc. listed undistributed income of \$571,073.00. For 1984, this same corporation listed distributions, other than dividend distributions, paid during the year to petitioner of \$669,060.00.

For 1983 and 1984, Don Travel Service NY, Inc. reported the following:

	<u>1983</u>	<u>1984</u>
Salaries	\$3,239,202.00	\$4,855,069.00
Cost basis of depreciable assets	1,737,501.00	2,249,533.00
Depreciation	710,024.00	1,009,250.00
Rent paid	438,288.00	768,602.00

For 1983 and 1984, Don Travel Service of Westchester, Inc. reported the following:

	<u>1983</u>	<u>1984</u>
Salaries	\$1,309,614.00	\$1,132,455.00
Cost basis of depreciable assets	573,871.00	707,387.00
Depreciation	270,159.00	405,169.00
Rent paid	134,356.00	170,113.00

The depreciable assets of both corporations included computers and office equipment.

The Division of Taxation ("Division") issued, on July 6, 1987, a Statement of Audit Changes recomputing petitioner's income with the explanation that "undistributed taxable income from an electing small business corporation is not personal service income." The Division allowed only the wages shown on the wage and tax statements as personal service

income, disallowing the amounts distributed by the subchapter "S" corporations to petitioner during the years at issue as well as the undistributed earnings of the corporations.

On August 7, 1987, the Division issued to petitioner a Notice of Deficiency asserting additional tax due of \$123,715.96, plus interest, for the years 1983 and 1984.

The accountant for petitioner and the subchapter "S" corporations during the years at issue testified at the hearing that the corporations were successful and profitable because of the personal efforts of petitioner. The accountant testified that petitioner was one of the first to employ computers in the travel agency business to set up systems for automated ticketing, reservations and customized billing statements. The combination of petitioner's efforts and extensive use of computers were the main factors which contributed to the growth of the corporations. The computer systems allowed the corporations to successfully compete for corporate travel business.

The accountant testified that the accounting firm made a mistake by not including in the wage and tax statements the amounts distributed during the years at issue. Furthermore, according to the accountant, petitioner sold the business in 1986 due to personal reasons and his concern over the total dependency of the success of the business on his own efforts.

SUMMARY OF THE PARTIES' POSITIONS

Petitioner contends that the distributions paid during the years at issue were in reality accrued commissions. It is the position of petitioner that these amounts were actually compensation for services actually rendered, and were omitted from the wage and tax statements through an error of the accounting firm.

Petitioner conceded at hearing that the undistributed earnings of the corporations cannot be considered as personal service income for purposes of computing the maximum income tax limitation.

The Division contends that the distributions made during the year were not earned income to petitioner. The Division points out that petitioner failed to testify at the hearing and thus an analysis of the relationship between his work performed and the reasonableness of his

salary cannot be made.

CONCLUSIONS OF LAW

A. Tax Law former § 603-A¹ provided for a maximum tax rate on New York personal service income. Subdivision (b)(1) of said section defined "New York personal service income", in pertinent part, as follows:

"(A) wages, salaries, or professional fees, and other amounts received as compensation for personal services actually rendered, but does not include that part of the compensation derived by the taxpayer for personal services rendered by him to a corporation which represents a distribution of earnings or profits rather than a reasonable allowance as compensation for the personal services actually rendered. In the case of a taxpayer engaged in a trade

or business in which both personal services and capital are material income-producing factors, under regulations prescribed by the tax commission, a reasonable allowance as compensation for the personal services rendered by the taxpayer shall be considered as earned income...."

B. That 20 NYCRR 100.4(c)(iii) provides as follows:

"Where an individual performs personal services for a corporation (including an S corporation), personal service income generally is only the portion of income received from the corporation that represents a reasonable allowance for salaries and other compensation for personal services actually rendered."

C. Internal Revenue Code former § 1348 provided a 50 percent maximum tax rate on personal service income, which, for taxable years beginning prior to January 1, 1979, was defined, in pertinent part as "any income which is earned income within the meaning of section 401(c)(2)(C) or section 911(b)...."²

Internal Revenue Code § 401 (former [c][2][C]), referred to in section 1348, provided that "earned income" for purposes of pension, profit-sharing and stock bonus plans of self-employed individuals and owner-employees included the following:

"(C) INCOME FROM DISPOSITION OF CERTAIN PROPERTY.--For purposes of this section, the term 'earned income' includes gains (other than any gain which is treated under any provision of this chapter as gain from the sale or

¹Repealed by Laws of 1987 (ch 28, § 5, eff April 20, 1987).

²Internal Revenue Code § 1348 was repealed by Pub L No. 97-34 for tax years beginning after 1981.

exchange of a capital asset) and net earnings derived from the sale or other disposition of, the transfer of any interest in, or the licensing of the use of property (other than good will) by an individual whose personal efforts created such property."

D. Internal Revenue Code § 911(a) provides an election for the exclusion from gross income of the foreign earned income of individuals. Internal Revenue Code § 911 (former [b]), referred to in section 1348, was

redesignated as section 911(d)(2) for taxable years beginning after December 31, 1981. Internal Revenue Code § 911(d)(2)(B) defines "earned income", in the case of a taxpayer engaged in a trade or business, as follows:

"In the case of a taxpayer engaged in a trade or business in which both personal services and capital are material income-producing factors,...a reasonable allowance as compensation for the personal services rendered by the taxpayer, not in excess of 30 percent of his share of the net profits of such trade or business, shall be considered as earned income."

E. Treas Reg § 1.1348-3(a)(3) provided, in pertinent part:

"Earned income from business in which capital is material. (i) If an individual is engaged in a trade or business...in which both personal services and capital are material income-producing factors, a reasonable allowance as compensation for the personal services actually rendered by the individual shall be considered earned income, but the total amount which shall be treated as the earned income of the individual from such a trade or business shall in no case exceed 30 percent of his share of the net profits of such trade or business...." (This regulation does not reflect the changes made to Internal Revenue Code § 1348 by Pub L No. 95-600 [Conclusion of Law "F", infra].)

F. Internal Revenue Code former § 1348 was amended by Pub L No. 95-600, effective for taxable years beginning after December 31, 1978, which removed the 30 percent limitation on the amount of income from a trade or business that could be treated as personal service income where capital was an income-producing factor.

G. It is clear that both personal services and capital were material income-producing factors in petitioner's business. The significance of capital is evidenced by the large investment in depreciable assets, including computers and office equipment. It is also noted that the physical premises of the business are also considered capital since leased property is considered capital for the purpose of determining whether capital is a material income-producing factor

(Moore v Commissioner, 71 TC 533). Since personal services and capital were material income-producing factors in petitioner's business, he was entitled to a reasonable allowance as compensation for the personal services which he rendered to the business.

H. Petitioner's claim that the distributions made during the year constituted compensation for personal services is not supported by the record in this matter. Initially, it must be noted that petitioner failed to testify at the hearing. Without the testimony of petitioner, or someone else with the knowledge of the personal services he performed, a determination cannot be made as to what amount of the distributions would constitute reasonable compensation for services actually rendered to the corporations. The corporations had a substantial investment in depreciable assets, including computers and office equipment. The salaries paid to employees equaled approximately one-third of the income earned by the corporations. Under these circumstances, petitioner has not sustained his burden to prove that it was improper for the Division to characterize the amounts shown on the wage and tax statements as personal service income and the distributions made during the years in issue as unearned income, in effect, generated by the capital invested by petitioner in his business. (See, Matter of Matson, Tax Appeals Tribunal, March 10, 1988.)

I. Petitioner's claim that the distributions made during the years in issue were mistakenly excluded from the wage and tax statements is also not supported by the record. No testimony or documentary evidence was introduced to establish how the claimed mistake was made by the accounting firm or the nature of such a mistake. Nothing was introduced into the record which would establish what the proper amount should have been on the wage and tax statements, such as corporate authorization for the salary claimed, the books and records of the corporations indicating treatment of the distributions as salaries or the method used to compute petitioner's salary. The distributions made during the years in issue were shown on both the corporate income tax returns and petitioner's personal income tax returns as distributions of the corporations' earnings. Under these circumstances, the distributions made by the corporations to petitioner during the years in issue were from the earnings and profits of the corporations and

do not constitute personal service income subject to the maximum tax limitation. (See, Paula Construction Company v. Commissioner, 58 TC 1055, affd 474 F2d 1345, 73-1 US Tax Cas ¶ 9283; Migliore v. Commissioner, 36 TCM 1004.)

J. The petition of Charles E. Benisch is denied and the Notice of Deficiency dated August 7, 1987 is sustained.

DATED: Troy, New York

4/18/91

ADMINISTRATIVE LAW JUDGE